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New evidence on stock market reaction to dividend announcements in India

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ABSTRACT

We revisit the information content of dividend announcements in India from 2012 to 2014 in a unique market setting which involves the introduction of Company's Act 2013. We find that announcement of increase in dividend lead to increase in stock prices, while the dividend decrease announcements are associated with decrease in stock prices. Firms that announce no change in dividends, experience insignificant negative returns around the event date. Our results contradict the tax-signaling model, which argues that higher taxes on dividends than capital gains are necessary for dividend announcements to be informative. The abnormal returns increase post the introduction of Company's Act 2013. The results of the firm-specific panel regressions indicate that the information content of dividends has a non-linear relation with the founder ownership consistent with the monitoring and rent extraction hypotheses.

1. Introduction

Many studies have documented that announcement of 'dividends' or 'changes in dividends' convey information to the market (Pettit, 1972; Aharony and Swary, 1980). Firms that pay dividends face less information asymmetry than those which don't (Howe and Lin, 1992; Khang and King, 2006; Li and Zhao, 2008). The information of dividend announcement may be interpreted as a positive signal if dividends are up to the expectations and leads to increase in the stock prices (Kato and Loewenstein, 1995; Shih-Jen and Wu, 2001; Nguyen, 2014; Al-Yahyaee, 2014). However, decreasing the dividends would create a negative signal which results in the fall in stock prices and thus the firm value (Yilmaz and Gulay, 2006) and (Pan et al., 2014). We have literature supporting both the positive as well as negative market reaction of dividend declarations. Despite so many studies, dividend policy still remains a controversial issue in the area of corporate finance (Andres et al., 2013). However, there is very scarce literature on the dividend puzzle for the emerging markets as majority of studies have been conducted on the US data (Dasilas and Leventis, 2011).

In this paper, therefore, we study the impact of cash dividend announcements made by different companies listed on the National Stock Exchange of India (NSE) for 2012 to 2014 period. To the best of our knowledge, this is the first study to investigate the effect of dividend announcements on stock returns before and after the Company's Act, 2013, which provides us with a unique market setting. We investigate the Indian stock market as it offers several institutional differences in contrast to other capital markets. *First*, in India, the dividends are tax-free in the hands of the investors in contrast to the US where the tax rate on the dividend income is more than capital gains. Literature suggests that taxes might have an impact

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on the dividend policy of firms (Dasilas and Leventis, 2011). To put it differently, absence of taxes provides a unique market setting to investigate the information content of dividends or tax-based dividend signaling model. If we find that the prices react to dividend announcements, it would suggest that higher tax on dividends relative to capital gains is not a sufficient condition for dividends to be informative (Al-Yahyaee et al., 2011).

Second, the striking feature of emerging markets such as India is the dominance of family-owned firms with substantial founder ownership and weak minority shareholder protection. Because of a high ownership, the managers will be limited in their ability to act at their discretion; therefore, the monitoring function of large shareholders makes the manager-shareholder conflict less severe (Andres et al., 2013). However, the conflict between the small and large shareholders may arise since the founders (family owners) do not only determine how the firm will be operated, but also how the firm's profits will be shared among its shareholders (La Porta et al., 1999), leading to expropriate the small shareholders. This problem is further exacerbated for emerging markets, such as India, where family (founder) members control firms by the pyramidal and cross-holding ownership that allow them to actually possess more control than their equity investment, with executive representations (Jameson et al., 2014). It implies that at lower levels of ownership, dividends are not important in signaling firm-specific agency problems; however, at higher levels of ownership, firms might reveal less firm-specific information to conceal the behavior of founders, which aggravates the degree of information asymmetry between insiders and outsiders (Attig et al., 2006). Therefore, an increase in the dividends reduces the potential resources that the founders could actually divert, and lead to the reduction of agency costs, known as rent extraction hypothesis (Gugler and Yurtoglu, 2003). Based on these arguments, we, therefore, expect a non-linear (hump shaped or U-shaped) relationship between founder ownership and information content of dividend announcements similar to Andres et al. (2013). At low levels of ownership, the monitoring effect dominates while at higher level, the rent extraction effects play the major role.

Third and the most important, in India, the Company's Act 1956 have been replaced with the new Company's Act 2013. The 2013 Act has introduced significant changes to the existing provisions of the 1956 Act which are likely to affect the existing practices followed by companies pertaining to declaration of dividends. With more autonomy given to the companies in the 2013 Act, we expect the effect of dividend announcements on returns to be more pronounced post 2013. To do so, we divide our data into three periods as pre-2013, post-2013 and the year 2013 to examine the differences in the impact of cash dividend payments on the stock prices before and after the introduction of Company's Act 2013.

Whether the investors use dividend announcements to price the stocks in India is an interesting empirical question. On the one hand, the absence of taxes and high concentration of ownership might have little or no impact on share prices; on the other hand, the introduction of Company's act 2013 might act as a boost to increase the information content of dividends. Therefore, we examine the impact of dividend announcements on the stock returns of the firm in the Indian context to find whether the net effect of all these factors is positive or negative. Similar to the developed countries, our results show that significant returns are generated as a result of dividend announcements which increase from 2012 to 2014. Firms increasing their dividends document an increase in share prices while those decreasing the dividends show an opposite effect. Moreover, those firms which do not change their dividends show insignificant average abnormal returns similar to Al-Yahyaee (2014).

Next we conduct the firm level panel regressions to examine the firm specific determinants of cumulative abnormal returns around the announcement date. We find that the size of the firm affects the returns negatively (small size effect). The information content of dividend announcements is more important for smaller firms since smaller firms are not adequately covered by financial analysts (Amihud and Li, 2006; Andres et al., 2013). Further, the results, as expected, indicate that the price reaction to dividend announcements is related to founder ownership in a non-linear way. Specifically, we document a U shaped relationship between information content of dividends and founder ownership, that is, founders use dividends as a mechanism to minimize the degree of information asymmetry between insiders and outsiders holdings only when founders' control rights exceed a threshold beyond which they effectively control the firm. The nonlinear relation indicate that when founder control is low, additional ownership may have positive incentive alignment effect, however, after a threshold, additional ownership exhibit negative effects as entrenchment increases (McConnell and Servaes, 1990). Such a finding is in line with Andres et al. (2013) that concentrated ownership is associated with lower (higher) dividends informativeness at lower (higher) levels of founder ownership. Our results are robust to firm-fixed effects and industry fixed effects along with various control variables. Moreover, the effect of these variables becomes more pronounced as the event window horizon expands and increases from 2012 to 2014.

Our paper makes important contributions to the existing literature. First, taking India as an example, we present additional evidence of the impact of dividend announcements (increase, decrease and no change) in the stock market prices in a unique market environment. Second, to the best of our knowledge, we provide the only study to examine the impact of Company's Act 2013 on the Indian corporate dividend policy. Third, we extend the debate on whether high founder ownership decreases the information content of dividends due to expropriation activities. Our results have important practical implications in that the policy makers should consider a country's overall institutional environment before stipulating a broad set of rules and regulations for firms. It is very crucial for the policy makers and the regulators to recognize how the concentrated ownership structure in India is associated with information content of dividends due to the incentive alignment and the entrenchment effects. Our finding that the stock prices react to dividends, suggest that higher tax on dividends over capital gains is not a necessary justification for dividends to convey information and finally, the introduction of the Company's act 2013 has led to an increase in the information content of dividend announcements.